CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 416

July 30, 1980

CALCULATION OF PREFERENCE INCOME FOR BANKS AND FINANCIAL CORPORATIONS

Syllabus:

Revenue and Taxation Code Section 23401(b), which is substantially similar to Internal Revenue Code section 57(a)(7), sets forth as an item of tax preference for banks and financial corporations "the amount by which the deduction allowable for the income year for a reasonable addition to a reserve for bad debts exceeds the amount that would have been allowed if the taxpayer maintained its bad debt reserve for all income years on the basis of actual experience as defined in section 585(b)(3)(A) of the Internal Revenue Code of 1954." Advice has been requested as to the proper method of calculating this preference income, specifically with respect to the beginning balance to be used.

Question:

When computing preference income under Section 23401(b), should the taxpayer's actual beginning bad debt reserve be substituted for the hypothetical beginning reserve if the actual reserve is lower than the hypothetical reserve?

Decision:

No.

Discussion:

Since the Franchise Tax Board has not adopted regulations under Section 23401(b), it is appropriate to refer to the federal regulations interpreting the analogous section of the Internal Revenue Code for guidance as to the proper application of the California statute. Cal. Admin. Code, Tit. 18, Reg. 26422.

Federal Reg. 1.57-1(g)(4) provides that the beginning balance for the first year in which the tax is imposed is to be the hypothetical reserve calculated on the basis of the preceding five years' experience, rather than the actual reserve balance at that time. The beginning balance for each subsequent year is the beginning balance of the preceding year decreased by bad debt losses during such year and increased both by recoveries of bad debts within the year and by the lower of the amount determined under Internal Revenue Code section 585(b)(3)(A) for such year or the amount of the deduction allowed for such year.

Thus, the hypothetical reserve is carried, with appropriate adjustments, through the years subsequent to the base year.

Reference may be made to the example contained in Reg. 1.57-1(g)(4); however, for franchise tax purposes, the first calculation should be made, not on the percentage method, but on the basis of a reasonable addition to the reserve as set forth in Cal. Admin. Code, Tit. 18, Reg. 24348(b).

Neither the regulation cited above, nor the example thereunder, addresses the situation when the beginning balance in years subsequent to the base year, calculated according to the method outlined above, is negative. If this should happen, it shall be assumed that an amount sufficient to bring the hypothetical reserve to zero was allowed in the preceding year, since the concept of a negative reserve, hypothetical or actual, is antithetical to the theory of a reserve for bad debts.